

BEFORE ~~THE~~ STATE BOARD OF EQUALIZATION;
OF THE STATE OF CALIFORNIA

In the **Matter** of the Appeal of }
MODESTO BOWL, INC. }

Appearances:

For Appellant: **Woodson J. Marsh, President**

For Respondent: **A. Ben Jacobson, Associate
Tax Counsel**

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board *on* the protest of Modesto Bowl, Inc., to proposed assessments of additional franchise tax in the amounts of \$126.80, \$432.05 and \$216.33 for the income years 1958, 1959 and 1960, respectively.

The question presented is whether compensation paid to appellant's president, manager and majority stockholder, **Woodson J. Marsh**, in excess of \$14,230, **\$18,592** and **\$10,359** for the years in question, should be allowed as deductible business *expense* pursuant to section 24343 of the Revenue and Taxation Code, which provides for a reasonable allowance for salaries or other compensation for personal *services* actually rendered,

Appellant commenced business in 1953, operating a bowling alley and attendant facilities. **Iris S. Kewin** originally owned most of the stock, but during the years in question, **Marsh**, her son, owned 70 percent and **Mrs. Kewin**, who was secretary-treasurer, owned 30 percent thereof. From the inception **Marsh**, appellant's key employee, was in complete managerial control of all corporate affairs, including, but **not limited** to, such responsibilities as the financial, **promotional, personnel**, and purchasing aspects of the **business**. In August 1959, he acquired a controlling interest in another bowling alley and **thereafter** divided **his time** equally between

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the two. Until then he had averaged seventy hours per Week of work for appellant, In 1960 Marsh received one-half of his salary from each business, while Mrs, Kewin received all of hers from the other bowling concern.

Among hfs other duties, Marsh is entirely responsible for arranging an annual tournament known as the Peach Tournament. Through his efforts this tournament has become the largest establishment-run bowling tournament from the standpoint of participation, in California, He is a member of the board of directors of the Northern California Bowling Proprietors* Association and serves as chairman of the association's Tournament Committee.

As of the close of the income year 1960 appellant had never paid any dividends, Outstanding capital stock had a par value of \$100,000, Other pertinent information for the years in question is as follows:

	<u>1958</u>	<u>1959</u>	<u>1960</u>
Gross Income	\$266,193	\$280,170	\$226,870
Net Income	31,299	19,913	19,587
Accumulated surplus as of Dec. 31	35,476	48,052	60,533
Marsh's salary			
Basic	10,400	15,600	7,800
Bonus	7,000	10,000	6,000
Mrs. Kewin's salary	5,200	5,300	-0-

The bonus was determined at the year's end when cash and profits were known.

For all the years at issue the total wages of other employees were more than twice the total officers' salaries, and in 1960 were more than four times as great,

Marsh's salary had been relatively low in the earlier years, ranging from \$4,800 in 1953 to \$10,300 in 1957. The higher salaries for the years in question were paid in part to compensate him for services during the less profitable prior years,

Similar businesses in nearby cities paid salaries lower than Marsh's to persons performing managerial duties. The extent of their duties and efforts has not been established. A competitor's manager received \$1,000 per month, 3 percent of annual net earnings, a \$300 monthly expense account and the

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use of an automobile, He was almost exclusively a promotion manager whose duties were considerably less demanding than Marsh's.

Respondent allowed as a deduction the full basic salary, plus a bonus equivalent to 10 percent of the net income before the bonus deduction for each year - \$3,830, \$2,992 and \$2,559 for the years 1958, 1959 and 1960, respectively, Respondent regarded the balance of the bonuses as distributions in the nature of dividends,

What is reasonable compensation depends upon the facts and circumstances of each particular case. Factors to consider include the employee's qualifications, the nature and scope of his work, the size and complexities of the business, comparison of salaries paid with gross and net income, prevailing general economic conditions, comparison of salaries with distributions to stockholders, prevailing rates of compensation for comparable positions in comparable concerns, the salary policy of the taxpayer as to all employees, and, in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years, (Mayson Mfg. Co, v. Commissioner, 178 F.2d 115.) The situation must be considered as a whole with no single factor decisive, (Mayson Mfg. Co, v. Commissioner, supra.)

The burden is upon the taxpayer to prove he is entitled to the deduction (Botany Worsted Mills v. United States, 278 U.S. 282 (73 L. Ed. 379)) and the existence of a family relationship justifies a close scrutiny of the facts. (L. Schepp Co., 25 B.T.A. 419.)

An analysis of the factors mentioned above indicates that appellant has met the burden of proof and that the total salaries paid represent reasonable compensation for personal services. The record establishes that Marsh was well qualified, that the scope of his work was broad and that the business was large.

In two of the years the ratio of total officers' compensation to gross income was well under 10 percent, and in 1959 was under 12 percent, These ratios were less than those in Mayson Mfg. Co, v. Commissioner, supra, where the salaries were held to be reasonable.

The ratio of officers' salaries to salaries of other employees is not unduly weighted in the officers' favor, Undoubtedly the ratio of officers' salaries to net income is high, but substantial net income remained after these salaries.. Net returns of 23.1 percent, 13.4 percent and 12.2 percent on invested capital after salaries for the three years constitute

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fair returns on the investment and support the conclusion that the compensation was reasonable. (Klug & Smith Co., 18 B.T.A. 966; Olympia Veneer Co., 22 B.T.A. 892.)

Respondent alleges that its survey of similar companies established that the compensation beyond that allowed by it was unreasonable. **However, it** appears that the extent of Marsh's activity was broader than the activity of the managers who were compared with Marsh.

Respondent stresses, in this closely held corporation, (1) the failure to pay dividends, (2) the determination of the bonus at the end of the year, and (3) the increase in compensation without a corresponding increase in duties. The failure to pay dividends loses much of its significance inasmuch as appellant retained a fair profit on invested capital. It appears that the bonuses were paid for past services in the prior years and this lessens the importance of the other two factors stressed by respondent. Where compensation is reasonable in amount, the fact it is for past services does not render it non-deductible. (Lucas v. Ok Fibre Brush Co., 281 U.S. 115 [74 L. Ed, 733].)

After weighing all the evidence, we conclude the entire salary paid to Mr. Marsh during, each of the years in question was reasonable within the meaning of section 24343.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Modesto Bowl, Inc., to proposed assessments of additional franchise tax in the amounts of \$126.80, \$432.05 and \$216.33 for the income years 1958, 1959 and 1960, respectively, be and the same is hereby reversed,

Done at Sacramento, California, this 23d day of June, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman
Alan Granston, Member
Chas. K. Kewen, Member
John W. Lynch, Member
William C. Allen, Member

Attest:

[Signature], Secretary